Supreme Court, U.S.
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No. 03-250

IN THE

Supreme Court of the United States

AMERICA WEST HOLDINGS CORPORATION, et al.,
Petitioners,

v.

NO. 84 EMPLOYER-TEAMSTER JOINT COUNCIL PENSION TRUST FUND, on Behalf of Itself and All Others Similarly Situated, et al.
Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

BRIEF FOR TPG AND CONTINENTAL RESPONDENTS IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether plaintiffs in a securities fraud class action, in which reliance on allegedly false statements can be proved only under a "fraud on the market" theory, can nonetheless show the "materiality" of those statements when public disclosure of the truth had no effect on the market price of the relevant securities.

RULE 29.6 STATEMENT

TPG Partners, L.P. is a limited partnership with one general partner, TPG GenPar, L.P. TPG GenPar, L.P. is a limited partnership with one general partner, TPG Advisors, Inc. Neither TPG Advisors, Inc. nor Texas Pacific Group, Inc. has a parent company. No publicly held company holds a 10 percent or greater interest in any of the aforementioned entities.

Continental Airlines, Inc. has no parent company and no publicly held company holds more than 10 percent of its stock.

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BRIEF FOR TPG AND CONTINENTAL RESPONDENTS IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI

Pursuant to Rule 12.6 of this Court, respondents TPG Partners, L.P., TPG GenPar, L.P., TPG Advisors, Inc., Texas Pacific Group, Inc., James G. Coulter, Richard P. Schifter, and Continental Airlines, Inc. ("TPG and Continental respondents") file this brief in support of the petition for a writ of certiorari.

STATEMENT OF THE CASE

This is a putative class action alleging violations of section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 of the Securities and Exchange Commission. Like most class action plaintiffs in modern securities fraud

litigation, plaintiffs do not allege—and, consistent with their status as class representatives, could not allege—that they *directly* relied on any misrepresentations by defendants. Plaintiffs instead proceed under the fraud-on-the-market theory approved in *Basic, Inc.* v. *Levinson*, 485 U.S. 224 (1988). In that case, this Court held that, in an efficient market, stock prices incorporate all available material information, including misrepresentations. Thus, a plaintiff who buys shares before a misrepresentation is publicly exposed is presumed to have relied to his detriment on the integrity of a stock's market price. As the Third Circuit has recognized, the logical corollary of this doctrine is that, if the market *fails* to adjust a company's stock price in response to newly disclosed information concerning that company, the information must *not* be material. *See, e.g., Oran* v. *Stafford*, 226 F.3d 275, 282-83 (3d Cir. 2000). Both the Third and the Fifth Circuits deny recovery under a fraud-on-the-market theory in the absence of such a market adjustment. *See id.*; *Nathenson* v. *Zonagen Inc.*, 267 F.3d 400, 415 (5th Cir. 2001).

The Ninth Circuit pointedly "decline[d]" to "adopt th[e] per se rule" followed by these other circuits and instead ruled for plaintiffs even though the share prices at issue actually *increased* on the days on which the supposedly material facts were disclosed. Pet. App. A24. The TPG and Continental respondents agree with petitioners that the Court's intervention is needed to resolve this disagreement. They file this response to stress that the conflict between the Ninth (and Eighth) Circuits and the Third and Fifth Circuits, and thus the question presented here, is not about the validity of an economic theory. The lower courts disagree over, and this case concerns, the question whether a fraud-on-the-market securities class action *lies* in a case where the alleged misinformation demonstrably did not affect the market.

The Ninth Circuit's decision conflicts not just with the decisions of the Third and Fifth circuits, but also with itself. The fraud-on-the-market theory relieves plaintiffs like these

of the obligation to allege direct reliance on a misrepresentation only if the securities at issue are traded in an efficient market. But the Ninth Circuit ruled for plaintiffs on the materiality of the alleged misrepresentations by suggesting that the market at issue—the New York Stock Exchange—suffers from undisclosed "distortions." Pet. App. A25. By allowing plaintiffs to rely on the efficient-market hypothesis in the *reliance* context yet simultaneously disregard it in the *materiality* context, the Ninth Circuit selectively applied the underlying premise of *Basic* in a universally pro-plaintiff manner inconsistent with any economic rationale.

1. Plaintiffs in this case purchased the publicly traded stock of petitioner America West Holdings Corp. between November 19, 1997, and September 3, 1998. Plaintiffs brought a putative class action on behalf of similarly situated purchasers against petitioners America West Holdings Corp., America West Airlines Inc. (collectively "America West"), and certain directors and officers of each company. Plaintiffs also named as defendants TPG Partners, L.P., TPG GenPar, L.P., TPG Advisors, Inc., Texas Pacific Group, Inc. (collectively "Texas Pacific Group"), certain directors and officers of TPG Advisors, Inc., and Continental Airlines, Inc. ("Continental"). Texas Pacific Group and Continental were at one time the two largest shareholders of America West. Plaintiffs allege that defendants violated section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. § 78j(b)) and Rule 10b-5 of the Securities and Exchange Commission (17 C.F.R. § 240.10b-5), and maintain that the director, officer, and shareholder defendants are liable as controlling persons under section 20(a) of the 1934 Act (15 U.S.C. § 78t(a)).

Plaintiffs claim that defendants falsely inflated the price of America West stock through a series of misrepresentations and omissions pertaining to America West's maintenance problems, a Federal Aviation Administration ("FAA") investigation of America West, and settlement negotiations with and the potential imposition of fines by the FAA. Plaintiffs allege that defendants purposely inflated

the price of America West stock so that Texas Pacific Group and Continental could sell their stock holdings for maximum possible gain upon the expiration on May 20, 1998 of a stockholder agreement provision limiting such sales. *See* Pet. App. A21.

The district court dismissed plaintiffs' consolidated amended complaint in October 2000, holding that plaintiffs failed to satisfy the pleading requirements of the Private Securities Litigation Reform Act of 1995 ("PSLRA"). *See* Pet. App. A61. The court permitted plaintiffs to file a new complaint, but cautioned that they "need to focus ... on pleading the factual allegations, if any, that support their claims of securities fraud against each defendant named in this action. This court is not interested in reading and dissecting another 106 pages of conclusory allegations." E.R. 113, at 16. Plaintiffs subsequently filed the complaint now at issue, the second amended consolidated complaint. Plaintiffs do not claim therein that they or the putative class members specifically knew of and directly relied on defendants' alleged misrepresentations. Instead, plaintiffs allege that America West stock "trades in an efficient market on the New York Stock Exchange" and that, "[i]n reliance on the integrity of the market, they paid artificially inflated prices for America West stock." Second Amended Consolidated Complaint ¶¶ 37, 165.

The district court granted defendants' motions to dismiss the second amended consolidated complaint. *See* Pet. App. A61-A80. As relevant here, the court held that the misrepresentations and omissions alleged by plaintiffs were immaterial as a matter of law because they had no effect on the price for America West stock. *See id.* at A70-A71. Specifically, America West's stock price did not react to two significant disclosures in 1998 of the facts that plaintiffs allege defendants previously had misrepresented or omitted.

First, on June 23, 1998, The Wall Street Journal reported that America West faced the prospect of substantial FAA fines for failing to oversee the maintenance

of its planes by outside contractors. The article revealed that America West and the FAA were at that time engaged in negotiations regarding civil penalties and that FAA negotiators expected to seek approval of a penalty within a week. The Wall Street Journal also noted that the FAA had placed America West on its "watch list" on June 9, 1998, because of labor issues at the airline. *See* Pet. App. A62, A70; *see also* Bruce Ingersoll & Scott McCartney, *America West Faces Possibility Of FAA Fines*, Wall St. J., June 23, 1998, at A4. The disclosure of America West's maintenance problems, the FAA investigation, and the looming civil penalty had no effect on America West's stock price, which rose slightly the day of the article and continued to rise in the following weeks. *See* Pet. App. A51, A70-A71; Pet. 4.

Second, on July 14, 1998, America West and the FAA announced that they had entered into a settlement agreement under which America West would pay a $5 million fine for violations of maintenance and operation rules. The agreement required America West to implement organizational changes related to safety and to devise comprehensive solutions to maintenance problems discovered during the investigation. *See* Pet. App. A13, A62-63. Once again, the announcement had no impact on America West's stock price, which rose slightly that day. *See id.* at A51, A70-A71; Pet. 4.[1]

Relying on a Third Circuit decision, the district court found that the absence of any market reaction to the disclosures of June 23 and July 14, 1998, demonstrated as a matter of law the immateriality of defendants' purported misrepresentations. *See* Pet. App. A71 (citing *Oran* v.

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[1] On September 3, 1998, over one-and-a-half months after the disclosure of the FAA settlement, America West announced that its third quarter results would fall short of analysts' estimates, and its share price declined from $20-5/16 to $14. *See* Pet. App. A15. The district court found that plaintiffs did not "bridge the gap between the July 14, 1998 settlement with the FAA and the September 3, 1998 decline in America West's stock price with supporting factual allegations of securities fraud." *Id.* at A66.

Stafford, 226 F.3d 275, 282-83 (3d Cir. 2000)). "The information about America West's maintenance issues, the FAA investigation and the FAA settlement agreement, all of which defendants' [*sic*] allegedly concealed, was obviously not material to the reasonable investor because the market did not react when this information was disclosed." *Id.* Finding that plaintiffs "had sufficient time and opportunity to plead their securities fraud claim" yet were "still unable to allege facts that sufficiently state a claim," the district court dismissed the second amended consolidated complaint with prejudice. *Id.* at A79-A80.

2. A divided panel of the Ninth Circuit reversed, holding that plaintiffs had "sufficiently pleaded the materiality of America West's misrepresentations regarding its maintenance issues, the FAA investigation, and the FAA settlement agreement." Pet. App. A26.

The panel majority expressly acknowledged and rejected the Third Circuit rule—relied on by the district court—that a plaintiff pleading a fraud on the market fails to satisfy the materiality requirement of a section 10(b) claim if disclosure of the allegedly misrepresented facts has no effect on the market price of the relevant stock. *See* Pet. App. A23-A24 (citing *Oran*, 226 F.3d at 282). Even though plaintiffs rely on the fraud-on-the-market theory in their second amended consolidated complaint and allege that the market for America West stock is efficient, the Ninth Circuit panel majority reasoned that the absence of any effect on the company's stock price could be explained by the fact that "[t]he market is subject to distortions that prevent the ideal of 'a free and open public market' from occurring." *Id.* at A25 (quoting *Basic, Inc.* v. *Levinson*, 485 U.S. 224, 246 (1988)). Because these "distortions" exist, the Ninth Circuit concluded that the Third Circuit's rule on materiality "would fail to address the realities of the market." *Id.* While the court rejected the efficient-market theory of *Basic* in the materiality context, it nevertheless adhered to the theory as a basis for reliance in securities fraud claims. The Ninth Circuit explained the *Basic* fraud-on-the-market theory as

"a rebuttable presumption of investor reliance based on the theory that investors presumably rely on the market price, *which typically reflects the misrepresentation or omission.*" *Id.* at A25 n.12 (emphasis added).

Having rejected the Third Circuit rule, the Ninth Circuit panel majority analyzed the materiality of defendants' alleged misrepresentations under the general, reasonable-investor standard of *Basic* and *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438 (1976). Under that standard, a misrepresentation or omission is material "if there is a substantial likelihood that a reasonable investor would consider it important in his or her decision making." Pet. App. A24 (internal quotation marks and citation omitted). Ignoring the actual reaction of real investors (*i.e.*, the market) to the disclosures of the facts allegedly misrepresented by defendants, the Ninth Circuit concluded that, in its own view, "[a] reasonable investor would find significant the information regarding a company's deferred maintenance costs, unsafe maintenance practices, and possible sanction." *Id.* at A26. The court accordingly held that plaintiffs sufficiently pleaded their section 10(b) claim.

Judge Tallman dissented. *See* Pet. App. A50-A60. Noting that America West's stock price rose slightly after both the Wall Street Journal article of June 23, 1998, and the announcement of the FAA settlement on July 14, 1998, he observed that "[t]he market's collective yawn to the allegedly material news is fatal" to plaintiffs' section 10(b) claim and that "[t]he majority's analysis is contrary to what the Supreme Court and our sister circuits have said in similar cases." *Id.* at A51-A52. Judge Tallman explained that the essential premise of the fraud-on-the-market theory adopted in *Basic* "is that in a modern and efficient securities market, the market price of a stock incorporates all available public information." *Id.* at A52. Following that premise, the Third and Fifth Circuits both hold that when a plaintiff relies on the fraud-on-the-market theory to satisfy the reliance requirement of a section 10(b) claim, the failure of the alleged misrepresentations to have an effect on the

relevant stock price precludes recovery. *See id.* at A53-A54 (citing *Nathenson* v. *Zonagen Inc.*, 267 F.3d 400, 415 (5th Cir. 2001); *Oran* v. *Stafford*, 226 F.3d 275, 282 (3d Cir. 2000); *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1425 (3d Cir. 1997)).

Judge Tallman would have followed the reasoning of the Third and Fifth Circuits and affirmed the dismissal of plaintiffs' complaint for not sufficiently pleading either reliance or materiality. *See* Pet. App. A57. The two elements "are not separate and unrelated concepts in securities law." *Id.* at A53. There was "no question that plaintiffs relied on the fraud-on-the-market theory to establish reliance," and there was "no dispute that, following the public disclosure of the information that is now alleged to have been withheld, America West's stock price did not significantly move in reaction to the news." *Id.* at A56-A57. With regard to reliance, Judge Tallman explained that plaintiffs "cannot invoke the fraud-on-the-market theory" because "the alleged misrepresentations did not skew the stock price" on which plaintiffs claimed to have relied. *Id.* at A57. Similarly, the absence of any market reaction undermined plaintiffs' allegations of materiality: "plaintiffs cannot show importance to a reasonable investor because, in the market, reasonable investors cared little about the FAA fine and settlement." *Id.* at A60. Finally, Judge Tallman explained that because of plaintiffs' failure to make particular allegations connecting the FAA investigation and fine with America West's poor third-quarter performance, the court could not, under the pleading standards of the PSLRA, "simply give plaintiffs the benefit of the doubt and view the market's reaction in September as indicative of the materiality of the misleading statements regarding the FAA investigation and settlement." *Id.* at A59.

REASONS FOR GRANTING THE PETITION

Under the decision below, securities plaintiffs invoking a fraud-on-the-market theory of liability can satisfy the materiality element of a section 10(b) civil claim even when the market reacts with a "collective yawn" (Pet. App. A51)

to public exposure of the alleged misrepresentations. The premise of that holding is that the market is affected by unidentified "distortions" (*id.* at A25) and therefore may fail to reflect material information. At the same time, the court necessarily presumed that plaintiffs and class members who were unaware of the alleged misrepresentations could claim reliance on market prices presumed to reflect those misrepresentations. The Ninth Circuit's decision contradicts both itself and the settled precedent of several other circuits, and this Court's intervention is needed.

I. THIS COURT'S DECISION IN *BASIC* V. *LEVINSON* RELIEVES PLAINTIFFS OF THE OBLIGATION TO PLEAD DIRECT, INDIVIDUAL RELIANCE ONLY IN CASES INVOLVING PUBLIC, MATERIAL MISREPRESENTATIONS CONCERNING SECURITIES TRADED IN EFFICIENT MARKETS.

A plaintiff bringing a private cause of action for a violation of section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 of the Securities and Exchange Commission must plead certain elements to state a valid claim.[2] Two of those elements are materiality and reliance. *See Basic*, 485 U.S. at 238 (materiality), 243 (reliance). The materiality element is objective. For a misrepresentation or omission to be material, there must be "'a substantial likelihood that a reasonable shareholder would consider it important in'" the decision to purchase or sell the security at issue. *Id.* at 231 (quoting *TSC Indus., Inc.* v. *Northway, Inc.*, 426 U.S. 438, 449 (1976)). Or, stated differently, "'there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.'" *Id.* at 231-32 (quoting *TSC Industries*, 426 U.S. at 449).

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[2] Section 10(b) and Rule 10b-5 are reprinted in full at pages A83 to A84 of the appendix to the petition.

The reliance element, in contrast, is subjective. For example, "'[i]n face-to-face transactions, the inquiry into an investor's reliance upon information is into the subjective pricing of that information by that investor.'" *Basic*, 485 U.S. at 244 (quoting *In re LTV Sec. Litig.*, 88 F.R.D. 134, 143 (N.D. Tex. 1980)). Absent an exception, "[r]eliance ... generally requires that the plaintiff have known of the particular misrepresentation complained of, have believed it to be true and because of that knowledge and belief purchased or sold the security in question." *Nathenson*, 267 F.3d at 413.[3] The reliance element provides an essential connection between the defendant's misrepresentation and *the plaintiff's* injury. *See Basic*, 485 U.S. at 243. The materiality and reliance elements are simplest to understand in the context of a face-to-face securities transaction. There, the defrauded purchaser must plead and prove that (1) the defendant seller's misrepresentation would be significant to the decision of a reasonable investor, and (2) the plaintiff purchaser in fact knew of and relied on the defendant seller's misrepresentation in deciding to purchase the security in question.

In *Basic*, the Court adopted a different approach to the reliance element with regard to specified securities fraud claims under section 10(b). As the Court recognized, "[t]he modern securities markets, literally involving millions of shares changing hands daily, differ from the face-to-face transactions contemplated by early fraud cases, and our understanding of Rule 10b-5's reliance requirement must encompass these differences." 485 U.S. at 243-44 (footnotes omitted). The fraud-on-the-market theory adopted by the Court in *Basic* accounts for these differences by relieving plaintiffs in certain circumstances from the requirement of pleading direct individual reliance on a defendant's misrep-

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[3] Under *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 153-54 (1972), positive proof of reliance may be unnecessary in omission cases (where plaintiffs allege that a defendant breached a duty to plaintiffs to disclose material information). Plaintiffs allege misrepresentations and the courts below made no reference to the *Affiliated Ute* principle.

resentation. Instead, plaintiffs may invoke a rebuttable presumption of reliance by alleging that a defendant made public, material misrepresentations regarding securities traded in an efficient market. *See Basic*, 485 U.S. at 246-48.

"'The fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business." *Id.* at 241 (quoting *Peil* v. *Speiser*, 806 F.2d 1154, 1160-61 (3d Cir. 1986)). In an efficient market, all material information regarding a company is rapidly incorporated into and reflected in the price of the company's stock price. "'[T]he market is interposed between seller and buyer and, ideally, transmits information to the investor in the processed form of a market price. . . . The market is acting as the unpaid agent of the investor, informing him that given all the information available to it, the value of the stock is worth the market price.'" *Id.* at 244 (quoting *In re LTV Sec. Litig.*, 88 F.R.D. at 143). Thus, when material misrepresentations are disseminated into the market, that information will be reflected in a false inflation or depression of the stock price. As the Court noted in *Basic*, "[r]ecent empirical studies have tended to confirm . . . that the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations." *Id.* at 246. But the necessary corollary, embraced by the Third Circuit (see below), is that if a stock price does *not* change in response to information introduced into an efficient market, the information is *not* material.

The fraud-on-the-market theory also depends on a second assumption: that individual investors *rely* on the integrity of market prices as a reflection of the true value of the relevant stocks. In *Basic*, the Court found it proper to presume that investors rely on the integrity of the price of stocks traded in an open, developed, and efficient market. Indeed, the Securities Exchange Act of 1934 was specially premised on this assumption: "'The idea of a free and open public market is built upon the theory that competing

judgments of buyers and sellers as to the fair price of a security brings [*sic*] about a situation where the market price reflects as nearly as possible a just price.'" *Id.* at 246 (quoting H.R. Rep. No. 1383, at 11) (alteration in original). Because a material misrepresentation disseminated in an efficient securities market will have the effect of falsely inflating (or depressing) the price of a stock, investors relying on the integrity of that price also rely *indirectly* on the misrepresentations that contributed to the increase (or decrease) in price. "Because most publicly available information is reflected in market price," the Court explained in *Basic*, "an investor's reliance on any public material misrepresentations, therefore, may be presumed for purposes of a Rule 10b-5 action." *Id.* at 247. The fraud-on-the-market theory thus substitutes an investor's reliance on the integrity of a market price for knowledge of and reliance on a misrepresentation affecting that stock price.[4] Class action plaintiffs frequently invoke the theory to avoid class-foreclosing issues about each individual plaintiff's direct reliance on particular representations. *See id.* at 242 ("Requiring proof of individualized reliance from each member of the proposed plaintiff class effectively would have prevented respondents from proceeding with a class action, since individual issues then would have overwhelmed the common ones."); *see also, e.g.*, *Patterson* v. *Mobil Oil Corp.*, 241 F.3d 417, 419 (5th Cir. 2001) (class actions may not

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[4] The fraud-on-the-market theory can also be viewed as a theory of causation applicable specifically to securities fraud committed in connection with stocks traded in an efficient market. Like the traditional reliance requirement, the fraud-on-the-market theory provides an essential connection between the defendant's material misrepresentation and the plaintiff's injury. *See Basic*, 485 U.S. at 242. A material misrepresentation causes a stock price to be inflated (or depressed), which in turn may injure the investor who trades in the security at the inflated (or depressed) price. If the misrepresentation is not material, and therefore has no effect on the trading decisions of investors in the market and no effect on the stock price, then there is no causal connection between the defendant's conduct and the plaintiff's injury. In these circumstances, recovery based on the fraud-on-the-market theory is therefore not justified.

be certified in fraud cases where individualized reliance is at issue).

II. THE NINTH CIRCUIT'S DISPOSITION OF THE MATERIALITY ELEMENT CONFLICTS WITH *BASIC* AND WITH DECISIONS OF THE THIRD AND FIFTH CIRCUITS.

The Ninth Circuit's decision on materiality is irreconcilable with the efficient-market premise of the Court's decision in *Basic*. There is no dispute that, as representatives of a putative class, plaintiffs (necessarily) have pled their claims under a fraud-on-the-market theory. This pleading is significant because of what happened when the facts allegedly misrepresented by defendants—America West's maintenance issues, the FAA investigation of the airline, and the potential (and ultimately actual) FAA civil penalties—were disclosed to the market in the Wall Street Journal article of June 23, 1998, and the public announcement of July 14, 1998. In both instances, actual investors found the information to be insignificant and the price for America West stock was unaffected. The Ninth Circuit ignored this failure of the actual market to react to the news and found that defendants' alleged misrepresentations were nevertheless material as pleaded because a hypothetical, reasonable investor likely would have found the misrepresented facts to be significant.

That holding contradicts not only reality, but also the critical premise of *Basic*, which plaintiffs have expressly relied upon in this case. Material information, for purposes of a section 10(b) claim, is information that is substantially likely to be significant to reasonable investors. *See Basic*, 485 U.S. at 231-32; *TSC Indus.*, 426 U.S. at 449. If an efficient market translates material information into a change in a stock price, as *Basic* holds, then the logical corollary must be true as well: The failure of a company's stock price to shift in response to the disclosure of information regarding that company signifies that the information is *not* material to actual investors. Indeed, the Court explained in *Basic* that an efficient market takes the

place of the reasonable investor in the process of valuing securities, communicating material information to investors in the form of a market price. *See* 485 U.S. at 244. Here, the valuation of America West's stock on the New York Stock Exchange did not change in response to the disclosures of June 23 and July 14, 1998. Empirically speaking, the information allegedly misrepresented or omitted by defendants was unimportant to investors. There was accordingly no basis for the Ninth Circuit to hold that a hypothetical, reasonable investor would nevertheless find the same disclosures *significant* to the valuation of America West stock.

The Ninth Circuit panel majority acknowledged (Pet. App. A24-A25) that, in refusing to recognize the immateriality of publicly disclosed information that has no effect on a company's stock price, its holding squarely conflicts with the Third Circuit's decision in *Oran* v. *Stafford*, 226 F.3d 275, 282 (3d Cir. 2000)). *Accord In re NAHC, Inc. Sec. Litig.* ("*NAHC*"), 306 F.3d 1314, 1330 (3d Cir. 2002); *In re Burlington Coat Factory Sec. Litig.* ("*Burlington*"), 114 F.3d 1410, 1425 (3d Cir. 1997). Under the Third Circuit's "market test," if a plaintiff proceeds on a fraud-on-the-market theory and alleges that the relevant securities are traded in an efficient market, the absence of any market reaction demonstrates the immateriality of the alleged misrepresentations as a matter of law and supports dismissal of a section 10(b) claim for failure to state a claim:

> [W]hen a stock is traded in an efficient market, the materiality of disclosed information may be measured post hoc by looking to the movement, in the period immediately following disclosure, of the price of the firm's stock. Because in an efficient market "the concept of materiality translates into information that alters the price of the firm's stock," if a company's disclosure of information has no effect on stock prices, "it follows that the information disclosed ... was immaterial as a matter of law."

Oran, 226 F.3d at 282 (quoting *Burlington*, 114 F.3d at 1425) (second alteration in original). In *Burlington*, *Oran*, and *NAHC*, the Third Circuit affirmed the dismissal of section 10(b) claims for failure to state a claim pursuant to this market test. *See Burlington*, 114 F.3d at 1414-15, 1424-25; *Oran*, 226 F.3d at 279, 282-83; *NAHC*, 306 F.3d at 1318, 1330.[5]

The Fifth Circuit employs a similar "market movement test" in fraud-on-the-market cases. Citing the Third Circuit's decisions in *Burlington* and *Oran*, the Fifth Circuit has held that "where the facts properly considered by the district court reflect that the information in question did not affect the price of the stock then the district court may properly deny fraud-on-the-market based recovery." *Nathenson* v. *Zonagen Inc.*, 267 F.3d 400, 415 (5th Cir. 2001). Applying this test in *Nathenson*, the court affirmed the dismissal of section 10(b) claims for failure to state a claim. *See id.* at 403-04, 413-19. The Fifth Circuit roots its market movement test in the reliance requirement rather than the materiality requirement, but the ultimate effect of the test is the same—dismissal of the plaintiff's complaint. Had plaintiffs brought their suit in either the Third or Fifth Circuits, dismissal of their complaint would have been affirmed because those courts would have properly and consistently applied the efficient-market theory of *Basic*. The Court should grant the petition to ensure the correct application of its decision in *Basic* and to resolve the division in the courts of appeals on the question presented here.

As the petition explains, the Ninth Circuit's holding conflicts in principle with decisions of the First and Fourth Circuits as well. *See* Pet. 12-15. The First Circuit has recognized, in contrast to the Ninth and consistent with

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[5] In both *Burlington* and *Oran*, the courts specifically noted that the plaintiffs had alleged that the company stock at issue was traded in an efficient market. *See Oran*, 226 F.3d at 283 n.3; *Burlington*, 114 F.3d at 1425. Here, plaintiffs similarly allege that America West stock is traded in an efficient market—the New York Stock Exchange. *See* Second Amended Consolidated Complaint ¶ 37.

Basic, that the *market* assumes the place of the "reasonable investor" in a fraud-on-the-market case:

> [B]y its underlying rationale, the presumption [of investor reliance on the integrity of stock prices] also shifts the critical focus of the materiality inquiry. In a fraud-on-the-market case the hypothetical "reasonable investor," by reference to whom materiality is gauged, must be "the market" itself, because it is the market, not any single investor, that determines the price of a publicly traded security.

Shaw v. *Digital Equipment Corp.*, 82 F.3d 1194, 1218 (1st Cir. 1996). The Fourth Circuit, following *Shaw*, has held the same:

> Because in a fraud-on-the-market case the "reasonable investor" for materiality purposes is not an individual plaintiff, but the market itself, a statement cannot be material if the hypothetical reasonable investor—that is, the market—would not regard the statement, in context, as significant.

Phillips v. *LCI Int'l, Inc.*, 190 F.3d 609, 617 (4th Cir. 1999). Under either the First or Fourth Circuit's formulation, a court would rely on the actual judgment of the market in assessing a plaintiff's satisfaction of the materiality element. A court would not speculate on its own about the judgment of a hypothetical investor, as the Ninth Circuit did here.

III. THE NINTH CIRCUIT'S DISPOSITION IS INCONSISTENT WITH THE SUPREME COURT'S TREATMENT OF THE RELIANCE ELEMENT IN *BASIC*.

For similar reasons, the Ninth Circuit's decision contravenes *Basic* with respect to the *reliance* requirement of a section 10(b) civil claim as well. The panel majority attempted to elude the necessary corollary of the efficient-market theory in the materiality context by surmising that "[t]he market" is subject to unenumerated "distortions." Pet. App. A25. In other words, the Ninth Circuit concluded that the market for America West stock may be inefficient,

notwithstanding plaintiffs' allegation to the contrary. But the Ninth Circuit's conclusion that the market for America West stock may be inefficient undercuts plaintiffs' entire theory of the case.

Like representatives of any putative securities class, plaintiffs have pled reliance only under the fraud-on-the-market doctrine. (Even if they could have responsibly pled direct individual reliance, such a pleading would have presented individual issues that would have precluded class treatment.) Plaintiffs claim that all members of the class relied on the integrity of the market price for America West stock, which was traded in an efficient market. *See* Second Amended Consolidated Complaint ¶¶ 37, 165. The existence of an efficient market is the central premise of the fraud-on-the-market theory. Both the Supreme Court and the courts of appeals recognize that plaintiffs may not invoke the presumption of reliance under the fraud-on-the-market theory in the absence of an efficient market.[6] The Ninth Circuit, however, assumed the *inefficiency* of the market for America West stock in answering defendants' materiality arguments. Because plaintiffs pled reliance only under the fraud-on-the-market theory, the panel majority's analysis of the materiality element should have dealt a fatal blow to plaintiffs' ability to satisfy the reliance element of their section 10(b) claims.

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[6] *See, e.g., Basic*, 485 U.S. at 248 n.27 (requiring allegation "that the shares were traded on an efficient market" to invoke presumption); *Semerenko* v. *Cendant Corp.*, 223 F.3d 165, 178 (3d Cir. 2000) ("Under the fraud on the market theory, a plaintiff in a securities action is generally entitled to a rebuttable presumption of reliance if he or she purchased or sold securities in an efficient market."); *Freeman* v. *Laventhol & Horwath*, 915 F.2d 193, 198 (6th Cir. 1990) ("The fraud on the market theory cannot be applied logically to securities that are not traded in efficient markets."); *West* v. *Prudential Sec., Inc.*, 282 F.3d 935, 937-38, 940 (7th Cir. 2002) (describing an efficient market as "the foundation of the fraud-on-the-market doctrine"); *Binder* v. *Gillespie*, 184 F.3d 1059, 1064 (9th Cir. 1998) ("[T]he presumption of reliance is available only when a plaintiff alleges that a defendant made material representations or omissions concerning a security that is actively traded in an 'efficient market' . . . .'").

Judge Tallman raised the reliance issue in dissent (*see* Pet. App. A56-A57), yet the panel majority held that plaintiffs' complaint sufficiently pled a section 10(b) claim. In the Ninth Circuit, then, plaintiffs in securities fraud litigation may pursue a bizarre "heads I win, tails you lose" theory of liability. They may allege efficient markets to avoid the requirement of pleading direct individual reliance yet may then deny the efficiency of those same markets to survive a challenge to the materiality of the defendants' alleged misrepresentations. In related contexts, other courts of appeals have rejected attempts by plaintiffs to characterize securities markets in such internally inconsistent ways for their own benefit. *See, e.g., Roots Partnership* v. *Lands' End, Inc.*, 965 F.2d 1411, 1419 (7th Cir. 1992) ("Roots cannot ask us to presume that the market reacted to the allegedly fraudulent prediction but ignored later information of Lands' End's actual earnings results, which information was announced months before plaintiff purchased."). The asymmetrical rule adopted below allows plaintiffs the benefits of the efficient-market theory without the costs. In this respect, the decision presents not just an ongoing circuit conflict, but significant and unjust consequences for securities fraud litigation throughout the Ninth Circuit, and this Court's intervention is warranted.

* * *

The question presented is particularly important because of the special need to dismiss nonmeritorious securities fraud class actions at the pleadings stage. This Court recognized long ago that because of the nature of securities fraud litigation, "even a complaint which by objective standards may have very little chance of success at trial has a settlement value to the plaintiff out of any proportion to its prospect of success at trial so long as he may prevent the suit from being resolved against him by dismissal or summary judgment." *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 740 (1975). Approximately twenty years later, Congress concurred in this judgment, imposing special requirements on securities

fraud class actions and adopting heightened pleading requirements for securities fraud claims in the PSLRA. *See* Pub. L. No. 104-67, § 101(b), 109 Stat. 737, 743 (1995). The Ninth Circuit decision permits plaintiffs' suit to proceed, but only by applying the efficient-market theory of *Basic* in a fundamentally inconsistent manner. This Court should grant the petition and restore consistency and order to this area of securities law by instructing the lower courts to dismiss claims, like those presented here, that are predicated on empirically immaterial, alleged misrepresentations.

CONCLUSION

For the foregoing reasons, the petition for writ of certiorari should be granted.

Respectfully submitted,

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